ESO 748

FARM BUSINESS ORGANIZATION[1]

The type of business organization for the farm firm may be the sole proprietorship, the partnership (general or limited), or the corporation (Subchapter S or Subchapter C). Typically, a farm business has only one type of business organization, but some large farm businesses may have more than one type of business organization. For example, the land may be owned by an individual operator while the operating enterprise is owned as a corporation with the operator and his son as stockholders.

Each type of organization has advantages and disadvantages. There are situations where each may be useful. The intent of the first part of this paper is to highlight the characteristics of each business organization form. One important characteristic is the income tax structure facing the business. The income tax structure is summarized in the second part of this paper.

Characteristics of Business Organization Forms

Sole Proprietorship

The sole proprietorship is standard in U.S. agriculture accounting for almost 90 percent of all farm businesses. It is created by and operated for the benefit of one individual. The sole proprietor personally is liable for all debt, breaches of contract, or accidents which might occur in the business. Most importantly, he enjoys all the profits and bears all the losses of the business. In essence, the business is an extension of the owner.

All taxes for the business are paid by the owner at his individual tax rates. Capital gains income and ordinary income from the business are combined with personal capital gains and ordinary income on the owner's tax return. The sole proprietor files a single tax return covering all his farm and nonfarm business activities.

The sole proprietorship is simple to organize and liquidate. No forms need be filed, no lawyers hired, and no fees paid. One simply declares himself the owner and transacts the affairs of

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the business. Liquidation occurs upon death of the owner or when transfer occurs. This does not mean that the sole proprietorship is freed from forms, fees, and lawyers during its operation. Our legal system assures every business of complexities such as income tax laws, contractual agreements, accounting standards, and government intervention through a variety of Federal and state regulations.

Having a sole proprietorship does not necessitate independent operation of a business. The proprietor might hire a manager, hire employees, enter into joint ventures with other sole proprietors, lease another's farm, or own shares in a corporation or cooperative. The distinguishing factor is an individual's possession of the sole rights and responsibilities in the business.

Partnership

The partnership is less prevalent than the sole proprietorship but still common in agriculture. Approximately 8.6 percent of U.S. farms are partnerships. Since agriculture continues to demand that the business have increasing amounts of capital, partnerships and other multiple owner farm businesses are likely to increase.

The partnership is an association of two or more persons as co-owners of a business. In some partnerships, all property is owned in the name of the partnership with each partner having an undivided interest in the assets. On the other hand, partners may retain individual land or equipment ownership and lease the assets to the partnership.

The primary disadvantage of a partnership is the unlimited liability of each partner. A partner is personally liable for all debts of the partnership and for the actions of the other partner when in the line of business. In addition, any partner may act as agent for the partnership. Imagine the potential for disaster if one partner has less than good judgment. This partner could decide to commit the firm to an activity which forces the firm into bankruptcy. All partners would be personally liable.

The life expectancy of partnerships may be rather short since dissolution may be forced by any general partner. When dissolution occurs, the assets may have to be liquidated and distributed to the owners, or another partner may purchase the interest of the dissatisfied partner and form a new partnership. Unless otherwise stated in the partnership agreement, death automatically terminates a partnership. At death of a partner, liquidation and distribution of assets would be an option as well as forming a new partnership or shifting to a sole proprietorship or corporation. Sale of a partnership interest by a partner to an outsider also dissolves the partnership. A decision would need to be made by the remaining partners as to whether a new partnership should be formed which includes the outsider.

Many of the disadvantages of a partnership can be overcome with appropriate provisions in a written partnership agreement. Points which the written agreement might address are: (1) scope of the business; (2) limit on partner's authority to act for the partnership; (3) length of life of the partnership; (4) sharing of management responsibility; (5) salaries for partners; (6) contributions of capital and labor by each partner; (7) sharing of profits and losses; and (8) continuation of the business.

The scope of the business might be that of farming or other enterprises associated with farming. A more restrictive definition of the scope of the business may limit a partner's authority to be involved in related activities. The authority for an individual partner to act may be further limited by a clause specifying majority agreement for most decisions. Another clause might limit the partnership's bank account to only business income and expenses.

The length of life clause may resolve some uncertainties over the permanence of the relationship. If one partner dissolves the partnership before the end of the specified length of life, the other partners can be given the right to damages against the partner who has breached the agreement. Of course, the partnership still may be terminated by agreement of all partners prior to the originally planned termination date.

Each owner should agree to share in management decisions and devote time to the business in accord with the partnership agreement. At the same time, it needs to be recognized that the business should take advantage of the individual talents of the owners by dividing management responsibilities. Daily operating decisions of an enterprise might be left to one partner while all partners share major policy decisions such as enterprise expansion and marketing strategies.

Salaries may be agreed upon at the time of writing the partnership agreement, or a procedure might be designed for annually deciding on salary levels. For example, the partners might annually review and renegotiate salaries. An alternative to salaries would be to allow partners to withdraw projected partnership profits. Of course, limitations would be placed on the amounts which might be withdrawn.

A balance sheet should accompany the partnership agreement to show the capital contributions of each partner. The tax basis as well as fair market value of each asset should be listed. These values determine, in part, the distribution of profits and losses. Generally, the owners should share profits according to their contribution of capital management and labor to the business. Sometimes, the split of profits is purposely inconsistent with the contributions of the partners. For example, a father and son partnership may evenly split the depreciation expense from the partnership even though father contributed all the depreciable assets. Or gains from the sale of breeding stock contributed by father may be distributed equally to father and son.

A record of each partner's capital contribution should be maintained throughout the life of the partnership. Annually, the contributions and undistributed profits of each partner should be added to these accounts, and the losses and distributions should be subtracted.

Finally, provisions to assure partnership continuity should be in the agreement. When these provisions are not present, any partner can force dissolution of the business. A withdrawing partner becomes a creditor and can force compensation for his share of the business. Death of a partner automatically terminates the business. Under any of these conditions, the livelihood of a partnership can be severely impaired.

To improve the continuity of the business, the partnership agreement can establish an option for the remaining partners to purchase the interest of a dissatisfied partner. The provision could specify the price or a specific formula for computing the price of the withdrawing partner's interest. This price may be intentionally set below fair market value to compensate the remaining partners for the damage caused by the withdrawing partner. The clause also could provide for an installment purchase of the selling partner's interest.

If the partners do not wish to exercise the purchase option and decide to permit the sale of a withdrawing partners interest, the agreement may limit the purchaser's rights of management and control. The provisions may even establish the purchaser as a limited partner with no part in the management of the business.

The partnership agreement may ease continuity problems at the death of a partner. The agreement may stipulate that the heirs remain as partners for a certain length of time after the death of a partner. Or the agreement might provide the remaining partners with either an option or an obligation to purchase the deceased partner's share. The method of determining the value of the share should be specified in the agreement.

If the sale of the deceased partner's share to the other partners occurs, an option for using an installment purchase may be provided. Another possibility is to fund the outright purchase with life insurance owned by the partners on the lives of each other. These "buy-sell agreements" are common in well-written partnership agreements.

Limited Partnership

Two types of owners characterize the limited partnership. The general partner has management responsibility and unlimited liability. The limited partner has no input into the firm's management, but his liability is limited to his personal contribution to the firm. In other words, the limited partner's only role is furnishing equity capital to the business.

The limited partnership may be attractive to the family farm with off farm heirs. General partnership interests could be transferred to a son or daughter concerned with continuing the business while limited partnership interests could be transferred to off farm heirs. Thus, income could be provided to off farm heirs while limiting their control of the business.

Written partnership agreements are a must with the limited partnership. Items which should be included are the contributions of the partners, the sharing of the profits, and the limitations on participation and liability of the limited partner. The agreement is recorded at the local court house so that potential creditors have access to the knowledge that a limited partnership exists. Needless to say, the farm creditor might look upon the limited partnership somewhat negatively since one or more of the partners would be escaping personal liability for the partnership's debts.

Corporation

There are two corporate forms, Subchapter C and Subchapter S. The Subchapter C or "regular corporation" is most often used in agricultural and non-agricultural businesses. The corporation is a legal entity. Furthermore, like any legal entity, it may buy, hold, and transfer property in its own name. Unlike the sole proprietorship or partnership, it may have an infinite life. Of course, corporations may fail like any other business; however, corporations generally have a longer existence than businesses with other forms of organization. This is due to their treatment by the law as a separate entity without having their mortality directly related to an individual.

One attribute of the corporation which is sometimes forwarded as an advantage is the ability to obtain outside capital. Ownership may be sold and debt may be issued to outsiders much more easily than with other forms of organization. This advantage is seldom realized in the farm business. Few individuals are willing to buy stock in a small business when the stock represents a minority interest and little control over the management of the firm. Unlike stock ownership in a larger firm, the shares are not easily sold, and the minority stockholder may be locked into a company with few dividends and few options to sell. Ability to obtain debt financing is seldom improved under the corporate structure. Most lenders evaluate the people behind the corporation and the prospects of repayment regardless of the form of organization.

Debt is normally assumed by the corporation. Unlike other business forms, the corporation is responsible for repayment, not the individual owners. Thus, the shareholders have limited liability in the sense that their personal assets cannot be seized to pay corporate debt in the event of bankruptcy. In practice, owners of small corporations do not always realize this limited liability. Many lenders recognize the limited liability aspect of a corporation and the lender's limitations for recovering debt owned by the business. Thus, the lenders may require the corporate officers to personally sign the loans and to commit their personal assets in the event of the corporation's bankruptcy.

The death of a key owner who has a key managerial or ownership position can disrupt the operation of the corporation. However, the decedent's shares of stock pass to any number of heirs without affecting the corporation's legal life. The individual owner with a minority interest has no right to force dissolution of the company. Compare this with the partnership where death of an owner generally means instant death of the partnership. If the partnership agreement continues the partnership by including the decedent's heirs as owners, they <u>may</u> have the power to force dissolution of the business if dissatisfied.

Written documents are a requirement of the corporation. Articles of incorporation must be filed with the state in which the business is incorporated. This document must outline the purpose of the corporation. Also, the articles contain the capitalization structure of the corporation. That is, the authorized number of shares, the voting rights of the shareholders, the rights on income, and preference of assets in case of liquidation are spelled out.

Several classes of stock can be authorized for the Subchapter C corporation with each class having different rights and preferences. Some may be <u>non-voting common stock</u> which has rights to receive income but no rights to vote on corporate decisions. <u>Common stock</u> owners have the ultimate voice in corporate decisions. Along with non-voting common stock, it is the residual claimant to income, enjoys most of the appreciation in the value of the company, and suffers most of the losses when the value of the company drops. Other stock may be <u>preferred stock</u> which has preference to liquidated assets before any other class of stock. This stock may also have a fixed annual dividend which is first claim to any income.

Accumulative preferred stock may be issued committing the company to pay fixed annual dividend in the future if current earnings are too small to pay the promised dividend.

Several types of debt can be authorized in the articles of incorporation. Besides the useful short and intermediate term notes and long term mortgages which the firm uses, the corporation may use other debt instruments. A bond may be issued which is simply a promise to pay a fixed coupon, e.g. $75 per year, with a fixed payment, e.g. $1000, at maturity. A more common debt instrument of agricultural corporations is the debenture. Unlike bonds, these are general credit obligations unsecured by specific property. In the event of liquidation, the holder becomes a general creditor to the corporation. Again, a fixed coupon is usually attached to the debenture. Subordinated debentures are debt instruments which rank behind all secured debt and all other unsecured debt in the event of liquidation. Generally, they are equivalent to equity owners in their claim on assets. However, this quality makes debentures useful. Banks and other lending institutions would regard them like equity in evaluating the financial structure of the firm. Also, interest paid to the holders would be tax deductible to the corporation. Dividend payments to preferred stock, a close substitute to subordinated debentures, are not tax deductible to the corporation.

The Subchapter C corporation pays taxes on its income. While the partnership or sole proprietorship simply passes income and losses through to the owner(s), the Subchapter C corporation is a tax paying entity. Any income passed on to shareholders in the form of dividends are not deductible expenses to the corporation and thus are taxed at corporate rates. Dividends are also included in the stockholders taxable income and taxed at personal tax rates. Thus, one of the disadvantages of the Subchapter C corporation is double taxation on dividends.

One of the strategies to avoid double taxation on dividends is to have the Subchapter C corporation reduce dividends to a minimal level and pay an equivalent amount to the owners in deductible expenses. These deductible expenses might include salaries to owners, interest on debt held by the owners, and fringe benefits to owner-employees. Care must be exercised in using these. Salaries must be reasonable compensation for personal services, and debt held by owners must not be excessive or appear to be equity disguised as debt. Legal counsel should be sought whenever these tax management strategies are used.

Subchapter S Corporation

The Subchapter S corporation is identical to the Subchapter C in most respects. It too is a legal entity, supposedly offering limited liability, easing transfer of ownership, facilitating ownership by several individuals, and having unlimited life.

Its distinguishing features are its method of Federal income taxation, a limit on the classes of stock which may be issued, a limit on the number and kinds of owners, and a restriction of the sources of income. First, its method of taxation is designed to remove the disadvantage of double taxation on dividends for small businesses. The corporation electing Subchapter S status is treated much like a partnership for tax purposes. The business does not pay taxes. Rather, each owner's salary, distributed dividends, and his share of capital gains, operating losses, and undistributed taxable income are passed through to the owner. He then includes these on his personal tax return and is subject to personal tax rates.

Only one class of stock may be authorized by the Subchapter S corporation. If non-voting common or preferred stock is desired, the Subchapter C form must be used. Shareholders cannot be corporations, non-resident aliens, partnerships, or certain types of trusts. The number of shareholders can be no greater than 15.

Subchapter S corporations cannot receive more than 20 percent of their income from rents, sale of stock, royalties, interest, or dividends. A potential problem exists with many farms if the landowning corporation rents land to an operating tenant. Only if the landowning corporation materially participates in the management of the land could Subchapter S status be elected.

Problems in Dissolving Corporations

Few businesses have infinite time horizons even when a corporate form is used. The corporation may have served its purpose and another business form be desired. Liquidation of the business may be another reason for dissolving a corporation. The problem with corporate dissolutions is that heavy Federal income taxes may result. Even though the assets are distributed to stockholders and a new partnership or sole proprietorship formed to continue business, capital gains tax results. Tax codes interpret corporate dissolution similar to a sale of stock. Cash and the value of property received by the shareholders in excess of the adjusted basis (current book value) results in a taxable gain to the shareholder usually at capital gain rates.

For the corporation facing dissolution, care must be taken to avoid double taxation - a corporate tax as well as individual tax on liquidated assets. However, there is generally no corporate tax on the gains upon dissolution if (a) the corporation adopts a complete liquidation plan, (b) all assets are distributed to shareholders, and (c) the distribution is completed within 12 months. Generally, the corporation does have some additional tax as a result of the dissolution. Depreciation recapture and investment credit recapture are the potential causes of this additional tax.

Income Tax Structure

There are a number of components of income taxes which need to be considered. These components include: (1) Federal tax rates; (2) capital gains; (3) capital losses; (4) minimum tax on tax preferences; (5) operating losses; (6) social security tax; and (7) state income tax.

Federal Tax Rates

Sole proprietorships, partnerships, and Subchapter S corporations are treated similarly by Federal tax laws. Owners of each of these pay personal income taxes on their share of business income. One can view business income as made up of three separate parts--payment to the owner's labor (salary or wages), payment to the owner's capital (distributed earnings), and income retained in the business (undistributed earnings). When a business is growing, large portions of the business income may be retained in the business. These earnings are used to repay debt, build up machinery and livestock inventories, and buy or improve land. Sole proprietorships, partnerships, and Subchapter S corporations essentially proportion undistributed earnings among owners. The earnings are then taxed as personal income for each owner.

The Subchapter C corporation may result in lower taxes in situations where earnings are not distributed to owners. Undistributed earnings of the Subchapter C corporation are taxed only once, and corporate rates are used. Prior to 1978, Subchapter C corporation rates were 20 percent on the first $25,000, 22 percent on the next $25,000 and 48 percent on earnings above $50,000 (Figure 1). Federal legislation (Revenue Act of 1978) lowered these corporate rates dramatically for corporate taxable incomes of $100,000 or less. Individual income tax rates continued to range from 14 percent to 70 percent; however, tax brackets were altered slightly by the 1978 legislation. In short, the tax rate restructuring had given additional incentive for the small business to organize as a corporation.

When earnings are distributed to the Subchapter C corporation's owners, the form of the distribution is critical to tax savings. When dividends are distributed, they are taxed twice. They are taxed once as part of earnings on the Subchapter C corporation's return. They are taxed again as income to the owner. This double taxation of dividends usually causes the Subchapter C corporate form of ownership to have higher taxes than partnerships or sole proprietorships if substantial earnings are distributed as dividends.

Capital Gains

The sole proprietorship, partnership or Subchapter S corporation pass net capital gains income on to the owners. Only 40 percent of the capital gains are included as part of

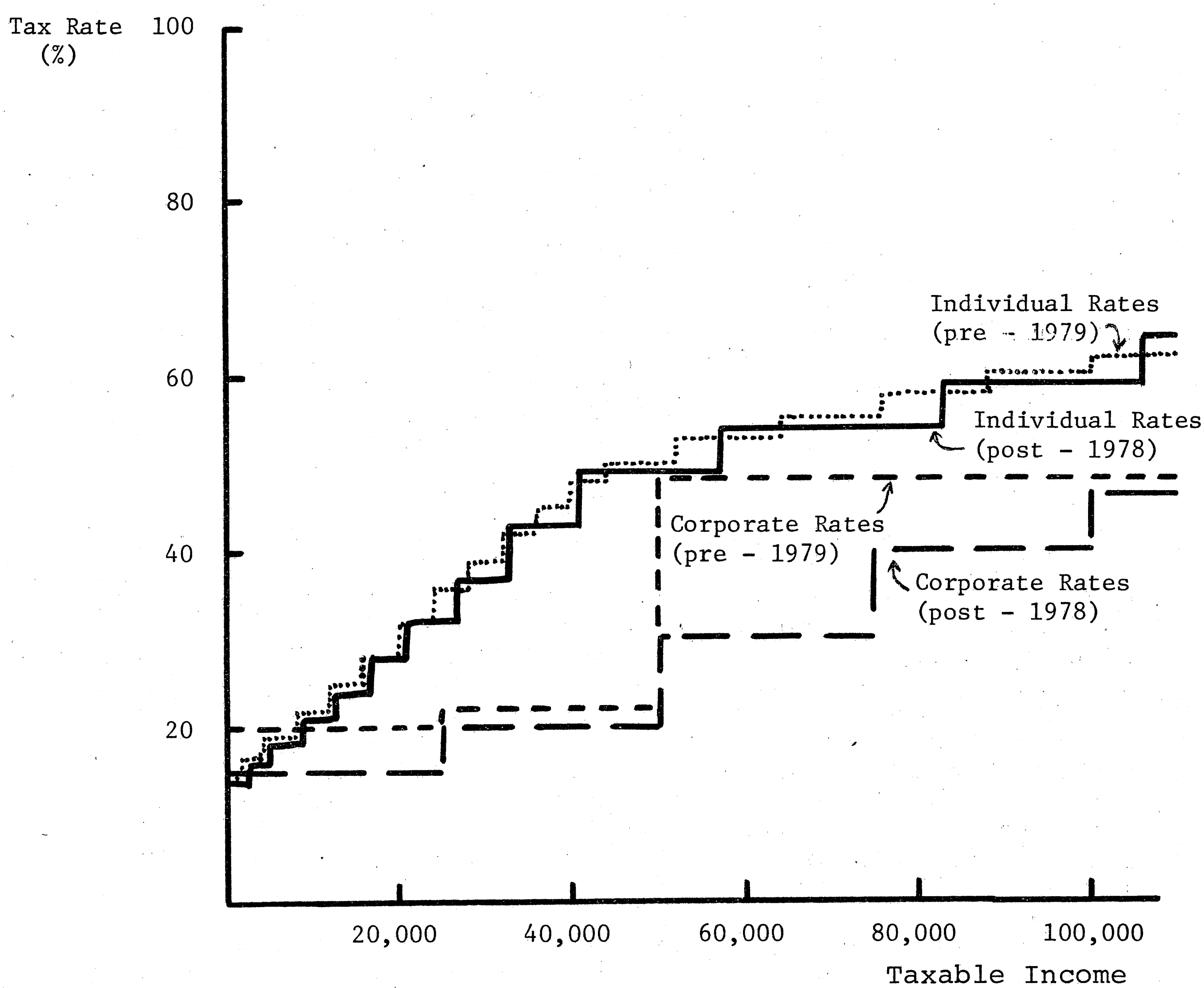

Figure 1. Federal Corporate and Individual Marginal Tax Rates for Taxable Incomes of Less than $110,000

ordinary income and taxed at individual rates. The Subchapter C corporation combines all capital gains with ordinary income to determine taxable income, and the capital gains tax rate is essentially the marginal corporate rate. An alternative capital gains treatment limits the net capital gains of corporations to a 28 percent rate. Thus, capital gains are generally subject to higher rates of taxation for the Subchapter C corporation than for the sole proprietorship, partnership or Subchapter S corporation.

Capital Losses

The individual taxpayer, having a sole proprietorship or a partnership share, can deduct net capital losses in the year they occur. Only 50 percent of net long term capital losses are permitted to be charged off against ordinary income. Also, net capital loss deductions are limited to the smaller of $3,000 or taxable income for the year. If net capital loss deductions exceed this limitation, they may be carried over to the following years until completely absorbed.

With the Subchapter S corporation, net capital losses are not passed on to the shareholders in the year they occur. Excess capital losses over gains may only be used by the corporation as a capital loss carryover. For the Subchapter C corporation, capital losses can be deducted only to the extent of capital gains. Any loss not absorbed can be carried back 3 years and, if not completely absorbed, carried forward up to 5 succeeding years.

Minimum Tax on Tax Preference

Many tax preference items, such as capital gains, accelerated depreciation on real property, and depletion, were subject to a minimum tax prior to 1978 legislation. In essence, the tax laws assured that taxpayers making use of these deductions did not reduce taxes below some minimum.

For the sole proprietor, partner, or Subchapter S shareholder, all tax preference items were totalled. Along with other preference items, one half of the net capital gains was included. The total tax preference items were reduced by the greater of (a) $10,000 or (b) one-half the regular tax liability less tax credits. These net tax preferences were subjected to a flat 15 percent tax rate. For the Subchapter C corporation, the minimum tax computation was similar except the tax preference portion of capital gains was different because of differences in capital gains tax preferences. After the 1978 legislation, a minimum tax on tax preferences remains for all taxpayers. However, individual capital gains are not tax preferences for the minimum tax. Capital gains are subject to another minimum tax referred to as the "alternative minimum tax."

Alternative minimum tax is applicable to all taxpayers other than Subchapter C corporations. Taxpayers must compute regular tax liability and increase it by the amount of any regular minimum tax. This sum must be compared with the tax computed under the alternative minimum tax formula, and the taxpayer pays the greater amount. The alternative minimum tax applies to ordinary income, adjusted itemized deductions and capital gains. If these items total between $20,000 and $60,000 the alternative minimum tax rate is 10 percent; between $60,000 and $100,000, the rate is 20 percent; and over $100,000, the rate is 25 percent.

Net Operating Losses

Operating losses from the sole proprietorship or partnership offset other income for owners. If this combination results in a net loss for the year, the loss can be carried back three years and forward seven years. The Subchapter S corporation is allowed to pass operating losses through to the owners to offset other income and to be carried over to other years. However, the Subchapter C corporation's operating losses cannot be passed through to owners although they can be carried over to offset corporate income in other years.

Social Security Tax

Social security self-employment taxes favor a sole propietorship or partnership. To illustrate, 1980 sole proprietors or partners paid 8.1 percent of the first $25,900 of earned income. The corporate form (Subchapter S or C) requires both the corporation and employee to pay 6.13 percent (a total of 12.26 percent) on the first $25,900 of owner-employee salary income. Partially offsetting this increased social security taxation for corporations is the fact that the corporation's 6.13 percent contribution is a deductible expense for the business.

State Income Tax

Typically, the sole proprietor's, partner's or Subchapter S shareholder's share of business income (distributed or undistributed) is subject to personal state income taxes. Only the Subchapter C shareholder's distributed earnings (salary, interest, or dividends) are subject to personal state income taxes. In Ohio, corporations (Subchapter S or C) pay the greater of a state franchise tax or state income tax. The state franchise tax is equal to 5 mills of the net worth. The income tax is 4 percent on the first $25,000 of corporate income and 8 percent on the excess.